IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1977

No. 77-918

THE FIRST NATIONAL BANK OF GLEN HEAD,

Petitioner,

v.

DONALD KATZ, Trustee in Bankruptcy of Oakland Foundry Company of Belleville, Illinois, Inc.,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONER'S REPLY MEMORANDUM

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The First National Bank of Glen Head (the "Bank"), the petitioner herein, replies to the opposing brief filed by the respondent, Donald Katz (the "Trustee"), trustee in bankruptcy for Oakland Foundry Company of Belleville, Illinois, Inc. ("Oakland").

I.

THE TRUSTEE'S DISTORTION OF THE RECORD

The Nature of the Glen Head Account. The Trustee asserts, without any foundation in the record, that the account maintained at the Bank (the "Glen Head account") was not an "ordinary business account, but was, instead, maintained as security for" the Bank's loan to Oakland. Opp. Brief, at 14-15. The Trustee, however, ignores his admission (Joint App., at 31) of the following facts in the record below:

> "10. Oakland used the Glen Head Account in the normal course of its business, paying its accounts payable on a regular basis from that account. Brede Testimony, at 9. In fact, from January 6, 1970 (until April 15, 1971, 'at least 260 checks' were drawn on the account, and from January 6, 1970 until October 1, 1970, only six of these checks were made payable to the Bank, and these were for federal

taxes. Plaintiff's Response Nos. 4, 5 and 6 to Request for Admissions.

> "11. The balance in the Glen Head Account fluctuated.... In July of 1969, for example, there were deposits of $18,012.05; the account opened that month with a balance of $11,638.84, but ended the month with a balance of $24,929.68. In August of 1969, there were deposits of $33,511.23, and the balance at the end of the month was $24,185.44. In September of 1969, there were deposits of $34,439.39, and the balance at the end of the month was $16,950.54. A similar pattern of activity continued until October of 1970. From October 1970 through March 1971, the account was less active and had lower balances...."

Joint App., at 27.

The Communications Between Oakland and the Bank. The Trustee charges that "Brede [the guarantor-principal of the bankrupt] had been in close contact with the Bank respecting Oakland's obligation to the Bank during the few months immediately preceding the set-off," and that "the Bank began asking that a

substantial 'compensating balance' be maintained...." Opp. Brief, at 8-9. Nothing in the record supports these charges, however. Although the Bank may have been skeptical about Oakland's financial condition,* nothing in the record shows that the Bank "had been in close contact" with Brede or any other representative of Oakland. Indeed, the Trustee never offered an affidavit or the deposition testimony of any person with personal knowledge of the facts to support his allegation.

The only knowledgeable officer of the Bank testified at his deposition as follows:

> "Q. Did you have any understanding with Mr. Brede with respect to those deposits on the part of Oakland?
>
> A. None whatever.

---

* Even if the Bank had knowledge of insolvency, which was not proved, that does not deprive a bank of its right of set-off. Plymouth County Trust Co. v. MacDonald, 60 F.2d 94, 96 (1st Cir. 1932); Citizens Nat'l Bank v. Lineberger, 45 F.2d 522, 530 (4th Cir. 1930) ("...such knowledge does not show collusion. ...").

Q. Did you have any conversation with Mr. Brede in that regard?

A. No.

* * *

Q. These monies were deposited with your knowledge or without your knowledge at the time they came in?

A. Without my knowledge.

* * *

Q. Well, did you have any conversations with [Brede] in this regard?

A. No.

Q. He did not at this time travel between Belleville, Illinois and his home in...New York?

A. This I don't know. But he didn't stop in to see me or call or see me."

Joint App. at 136-37.

In response to questions asked by the Trustee's counsel, Brede, president of Oakland, also testified under oath in the bankruptcy court as follows:

"Q. During the months prior to bankruptcy had you been in contact with The First National Bank of Glen Head concerning your sale of the building?

A. No. About the only contact I had was right towards the end in June or July. I got all the people together here in Belleville and told them that we were in financial trouble and I called the bank up in New York and told them that we were in financial trouble."

Joint App., at 190. Thus, the only two persons with knowledge of the facts contradict the Trustee's unfounded charge.

The Bank's Purported Knowledge. The Trustee also asserts that the Bank "had full knowledge of the character of the [activity] in Oakland's account.... Famighetti [the Bank's president] admitted observing the build-up himself, and the Bank knew how few withdrawals were being made on the account, knew the nature of at least some of those withdrawals, since most were to pay interest to the Bank itself, and knew that such was not the pattern of an ordinary business account." Opp. Brief, at 12-13. Again, there is nothing in the record to support these charges. The following excerpt from

the record, taken from the deposition of the Bank's president, discloses the real nature of the Bank's knowledge:

> "Q. Did anyone bring to your attention the fact that within a space of a two-or three-month period there was a $100,000 build-up of deposits?
>
> A. Not particularly to that amount. It was my own observation. We have a periodic indication of the deposits on hand. When they rise above the $25,000 level and these reports will flow through so we have a better sensing of our companies, and suddenly I saw that balance appear which indicated that deposits were being made.
>
> Q. To the extent that I have gone into?
>
> A. No. Just that it was an increase. I can recall thinking, well, he [Oakland] has turned the corner and I was happy to see it.
>
> Q. Well, did you have any conversations with him in this regard?
>
> A. No."

Joint App., at 137.

The Status of the Funds in the Glen Head Account Prior to Set-Off. According to the Trustee, "it is likely that had [checks] been drafted [against the Glen Head account] they

would have been dishonored [by the Bank] during the final days before set-off." Opp. Brief, at 22 (continuation of n. 9 from p. 21). This assertion is not only speculative, but also without factual basis. It was not until June 29, 1971, one day before the set-off that the Bank "placed a freeze on Oakland's account barring all withdrawals." Opp. Brief, at 13. Moreover, in the court below and in the district court, the Trustee admitted that Oakland could withdraw funds from the Glen Head account at will. Joint App., at 35, 40 ("The Glen Head Account was a general account, and there were no restrictions on Oakland's right to make withdrawals."). Significantly, the Trustee does not deny that a judgment or attachment creditor of Oakland could have reached the funds on deposit in the Glen Head account at any time prior to the Bank's set-off on June 30, 1971. Petition, at 11-12.

The Trustee's Response to the Bank's Motion for Summary Judgment. The Trustee also claims that he "responded to the bank's motion for Summary Judgment with substantial, powerful evidence." Opp. Brief, at 28. The affidavit submitted by the Trustee's counsel, however, was the only affidavit relied on to oppose summary judgment. More importantly, the substance of the lawyer's affidavit can be summarized as follows:

> (a) He "took possession of all books and records on the [bankrupt's premises]." Joint App., at 32.
>
> (b) Certain records "were under [his] direction, supervision and control...." Id.
>
> (c) He "caused a search to be made of the law records of lawsuits filed... against the bankrupt to determine whether there were outstanding judgments or lawsuits pending...from January 1, 1971 through July of 1971," and that "a search disclosed" only one suit.

Joint App., at 33. Thus, nobody with personal knowledge of the facts has even raised an issue as to (a) whether the Bank dealt in bad faith in accepting Oakland's deposits, (b) whether the

Bank was aware of an intentional build-up, or (c) whether withdrawals from the Glen Head account were restricted in any way. The documents in the record tend to show, at most, that Oakland intended to deposit funds in the Glen Head account. Nothing even tends to implicate the Bank. See, Modern Home Institute, Inc. v. Hartford Acc. & Indemnity Co., 513 F.2d 102, 109-10 (2d Cir. 1975) ("If the most that can be hoped for is the discrediting of defendants' denials at trial, no question of material fact is presented."), citing First National Bank v. Cities Service Co., 391 U.S. 253, 290 (1968).

The Bank's Acceptance of Oakland's Deposits. According to the Trustee, it could easily be found that the Bank "did not accept these deposits [from Oakland] in the ordinary course of business;" the Bank's "compensating balance" requirement is cited as proof. Opp. Brief, at 16. Compensating balances are typically required, however,

when a bank loans money to a small business. See App. I, at 16-17. Congress recognized this fact within the past year when considering bankruptcy reform legislation. H.R. Rep. No. 595, 95th Cong., 1st Sess. 184-86 (1977) ("In order to encourage a bank to carry a debtor through difficult times without the threat of losing a setoff right after bankruptcy, it may be desirable to permit ... bank setoff in any event.") (discussed at pps. 25-26 of the Petition herein). See also, Justman, "Comments on the Bank's Right of Setoff Under the Proposed Bankruptcy Act of 1973," 31 Bus. Law. 1607 (1976).

II.

THE UNDISPUTED CONFLICT WITH
THE DECISIONS OF OTHER CIRCUITS

The Trustee does not deny that the Second Circuit's decision conflicts with Citizen's Nat'l Bank v. Lineberger, 45 F.2d 522 (4th Cir. 1930). In that case, the evidence was undisputed that there had been communications between the bankrupt's principal guarantors and the president of the defendant bank, who was the brother-in-law of one of the guarantors, before deposits were made in the bankrupt's account. 45 F.2d at 523-24. Although no such evidence exists here, the Trustee avoids discussing the facts of Lineberger, obviously because there is a conflict between the Second and Fourth Circuits. See Petition, at 16-18.

The Lineberger decision, supra, was premised on this Court's decision in New York County Nat'l Bank v. Massey, 192 U.S. 138 (1904), which imposed a "fraud or collusion" requirement that the Trustee ignores. The Trustee's attempt to distinguish Massey from this case (Opp. Brief, at 21-22) is hardly convincing, and is inaccurate, as shown above.

Most of the Trustee's objections to the Bank's set-off here were made long ago by the late Professor MacLachlan and the National Bankruptcy Conference, but were rejected by Congress. Professor MacLachlan described the problem as follows:

"The existence of the banker's right to set-off his liability on the deposit against the debts of the depositor to the bank means that the deposit may be regarded as part of the banker's security. Hence, deposits made while the depositor is insolvent and the banker has reasonable cause to believe it, are transfers securing the bank, the effect of which will enable the bank to get a greater percentage of its debt than other general creditors. If the bank is already otherwise fully secured, so resort to the deposit is unnecessary, the question will not arise, but the question has frequently arisen when a deposit goes to increase the security of the bank where other security is inadequate. The banks in such cases have generally maintained successfully that when the deposit was made the depositor intended to have it available to pay his bills, just the way bank accounts are commonly used, and that the bank accepted it with the understanding that it was just like any other deposit.

"The acceptance of this view has been carried so far as to protect the bank after the debtor had circularized his mercantile creditors proposing a 25% composition, and stating that pending a creditor's meeting the assets will be preserved in the interest of creditors, and that any attempt by a creditor to obtain a preference by legal proceedings or otherwise would precipitate insolvency proceedings. On the day of the adjourned creditors' meeting the petition in bank-

ruptcy was filed, and the bank then appropriated the deposits made in the meantime to the payment of the debtor's obligation to it. During this interval the bankrupt withdrew no checks in favor of mercantile creditors. [Citing Massey and Lineberger, supra.] The court achieved this result by following the doctrine announced by the Supreme Court in such cases that making a bank deposit is not a transfer. Pragmatically, however, a bank deposit may and usually does, if the banker is alert, create a security for the bank. For all that appears, the depositor is free to withdraw the deposit anytime after he makes it, but if bankruptcy or insolvency in the commercial sense intervenes, the bank will extinguish the account by way of enforcing a set-off. True, the cases do not permit the bank to apply and retain deposits for a special purpose or deposits made pursuant to an agreement between the bank and the depositor that the account be built up while other creditors are kept waiting, but the mere fact that such a result was achieved is considered insufficient evidence of an agreement to that effect, and more specific evidence is frequently not forthcoming. The close working relations frequently maintained between a bank and its commercial depositor may hinder the proof of any definite agreement to prefer the bank.

* * *

"In the light of these considerations the National Bankruptcy Conference approved, as part of its drafts of the Chandler Bill, a proposed amendment to section 68 directed at covering the converse case to that covered in section 68b. That is, it dealt with transactions whereby a creditor of the bankrupt becomes the bankrupt's debtor with a view to set-off within four months of bankruptcy, and with knowledge or notice that the debtor is insolvent or has committed an act of bankruptcy. The proposal further specifically referred to bank deposits made under such circumstances that other transfers would be voidable preferences and proscribed set-off in such cases.

"It is not surprising that banker opposition caused the amendment to be stricken from the Chandler Act."

MacLachlan, Bankruptcy §§ 291-92, at 342-43 (1956)(citations omitted). In sum, the purported problem cited by the Trustee has already been called to the attention of Congress. The Second Circuit should not have attempted to change the applicable law* when at least two

* That the district court's decision represents the applicable law is reflected in a newly released law school publication, D. Epstein & J. Landers, Debtors and Creditors, 474-78 (1978), in which the authors reproduce the text of the opinion (App. II, at 18-26) and approve its reasoning.

Congresses, recognizing the benefits of the right of set-off, have refused to do so.

III.

THE TRUSTEE'S PURPORTED AUTHORITIES

The cases cited by the Trustee are easily distingishable. They confirm that a bank must be culpable in order for it to be held liable.

Merrimack Nat'l Bank v. Bailey, 289 F. 468 (1st Cir.), cert. denied, 263 U.S. 704 (1923) (Opp. Brief, at 16), is distinguishable because the bankrupt "was being liquidated by its creditors; naturally enough, the proceeds of liquidation were being deposited in various creditor banks. The understanding that no preferences should be given was, in effect, nothing but a recognition of the requirements of the law." 289 F. at 470. Unlike this case, the defendant bank knew all of the details of the bankrupt's financial condition and understood

the restriction on the deposited proceeds prior to accepting the deposits from the bankrupt. 289 F. at 469.

In Gates v. First Nat'l Bank, 1 F.2d 820 (E.D. Va. 1924) (Opp. Brief, at 16), deposits were made after the bankrupt suspended operations, and the defendant bank had full knowledge of this fact, primarily because an officer of the bank had been chairman of a creditors' committee. According to the court, the "[bank's] receipt of money ... was with unmistakable knowledge of bankruptcy," and the bankrupt's deposits were not "made in the ordinary course of business." 1 F.2d at 823-24. The Bank had no such knowledge here and had neither solicited nor participated in the build-up of the Glen Head account.

Likewise, in Wilson v. Nebraska State Bank, 126 Neb. 168, 252 N.W. 921 (1934) (Opp. Brief, at 16), an insolvent manufacturer, "with the knowledge, advice and approval of the managing officers" of the defendant bank,

sold certain assets for the purpose of liquidating its affairs. 525 N.W. at 922. One day after the sale proceeds were deposited with the bank, it set off such funds against an outstanding debt of the bankrupt. Id. No such knowledge existed here prior to Oakland's deposits, however, and Oakland's deposits were numerous and frequent. Joint App. 23, 27, 31.

Similarly, in Irving Trust Co. v. Bank of America Nat'l Ass'n, 68 F.2d 887 (2d Cir.), cert. denied, 292 U.S. 628 (1934) (Opp. Brief, at 17), the bank "had no right of set-off because the deposit was received after it had reason to know of the bankrupt's insolvency and after it had forbidden withdrawals from, or certifications against, the bankrupt's account." 68 F.2d at 890 (emphasis added). Here, however, the Bank had imposed no restrictions on Oakland's account, having learned of Oakland's financial problems for the first time on June 29, 1971, after the

deposits had been made by Oakland. Joint App., at 170-71, 190-91. The Bank set off here only after it acquired notice of a problem. App. at 23, 190-91. And in Mechanics' and Metals Nat'l Bank v. Ernst, 231 U.S. 60 (1913) (Opp. Brief, at 17), "[t]he so-called deposit of $54,048.08 was paid in after the cashier had forbidden the payment of checks against the deposit account and therefore rightly was held to be a payment and a preference. A set-off was properly denied." 231 U.S. at 67. Such facts do not exist here.

The Trustee's reliance on Cusick v. Second Nat'l Bank, 115 F.2d 150 (D.C. Cir. 1940) (Opp. Brief, 19-20), is also misplaced. That case merely dealt with whether the defendant bank "had reasonable cause to believe, at the time of the deposits, that payment of the notes would effect a preference, i.e., reasonable cause to believe that the [bankrupt] was then insolvent in the

bankruptcy sense." 115 F.2d at 152. The issue here, however, is not whether the bank had "reasonable cause" to believe Oakland insolvent but whether the Bank "acted in good faith in accepting the deposits or whether the [Glen Head account] in fact was a general deposit account." App. I, at 3.

In Mayo v. Pioneer Bank & Trust Co., 270 F.2d 823 (5th Cir. 1959), cert. denied, 362 U.S. 962 (1960) (Opp. Brief, at 20), the proceeds received on a contract were immediately transferred by the bankrupt by means of a debit memorandum "solely to repay the loan" from the defendant bank which had reasonable cause to believe the depositor to be insolvent at that time, "and the depositor was in fact insolvent." 270 F.2d at 836. No such evidence exists here.

Blue v. Herkimer Nat'l Bank, 30 F.2d 256 (2d Cir. 1929) (Opp. Brief, at 23), is easily distinguishable. There, the moneys

were collected and deposited by the defendant bank in a special bank account "for the purpose of" being applied against the maturing notes of the bankrupt. 30 F.2d at 259.

> "It [the bank] had full knowledge of the bankrupt's financial condition from the statement furnished, and from its method of handling his moneys when received in payment of the contract it displayed a desire to protect itself. To a considerable extent, the defendant took supervision of his finances in carrying out his contracts. It had reasonable cause to believe that it was obtaining an advantage over the creditors, and is chargeable with the intent of creating a preference for itself."

30 F.2d at 260. The Bank here, however, had no control over the business or the checking account of Oakland. Indeed, the Trustee has admitted that the Glen Head account was of a general, unrestricted nature. Joint App., at 22, 30.

In In re Almond-Jones Co., Inc., 13 F.2d 152 (D. Md. 1926), aff'd sub nom. Union Trust

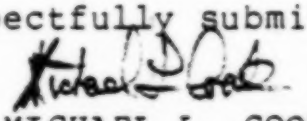
Co. v. Peck, 16 F.2d 986 (4th Cir.), cert. denied, 273 U.S. 767 (1927) (Opp. Brief, at 23), "both the [defendant] bank and the bankrupt ... intended ... that the deposits should be applied [by the bank]...." 13 F.2d at 157. The Bank had no such intent here when Oakland made its deposits, and none has been shown.

CONCLUSION

The need for plenary review of the decision below is indisputable. Indeed, the Trustee does not deny that this Court and other circuit courts have imposed a requirement of "fraud or collusion" between the bankrupt and the bank, or at least some culpable act by the bank, to deprive it of its recognized right of set-off. The Trustee's

fictionalization of the record below should not preclude this Court's review of a decision that will have an adverse effect on all financially troubled businesses.

Respectfully submitted,



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